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Special Report

WHY BANKS WANT YOUR BUSINESS

Financial Strategies

PAY-AS-YOU-GO PLAN FOR FAST GROWTH

CAN MONEY BUY MOTIVATION?

Stanley Ringel, Chairman
Coradian Corp.

SURVIVING A BUSINESS DIVORCE

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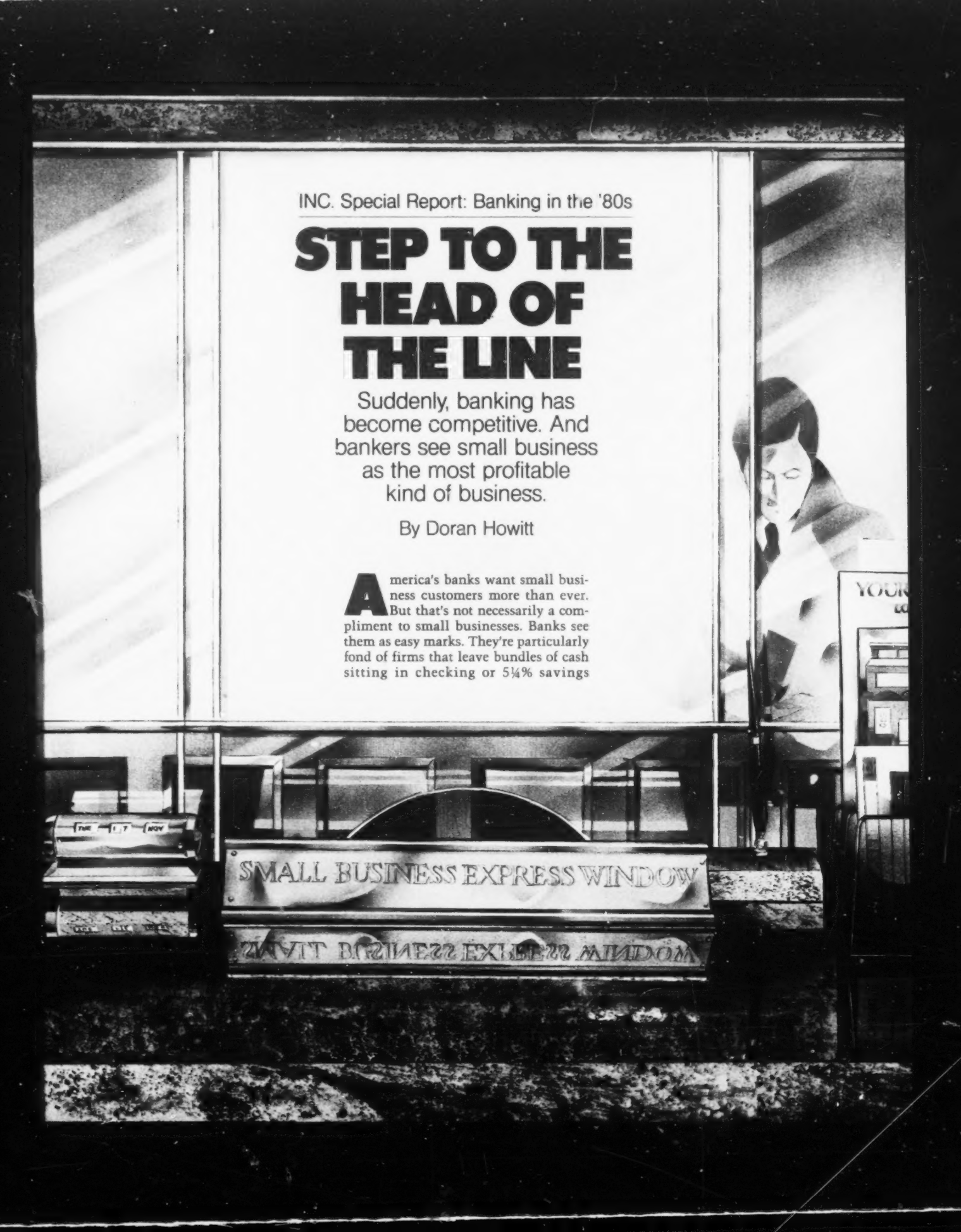

INC. Special Report: Banking in the '80s

STEP TO THE HEAD OF THE LINE

Suddenly, banking has become competitive. And bankers see small business as the most profitable kind of business.

By Doran Howitt

America's banks want small business customers more than ever. But that's not necessarily a compliment to small businesses. Banks see them as easy marks. They're particularly fond of firms that leave bundles of cash sitting in checking or 5¼% savings

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BANKING IN THE '80s

accounts—cash on which the banks earn 15% to 20%.

In the 1960s and 1970s, America's money-center banks and large regional banks couldn't be bothered with small companies. Why fuss with $50,000 loans when you can swing $50-million corporate deals for the same trouble or when you can syndicate loans in the hundreds of millions of dollars to foreign institutions and governments?

In the mid-1970s, though, that game started to change. Larger corporations learned how to sell commercial paper, bypassing the banks and eliminating their middleman's markup. When interest

Tom Barr/Black Star

Ford: Two years ago, Mellon wasn't paying much attention to small business.

rates started climbing in the late 1970s, these corporations also grabbed back valuable dollar balances that they had let sit in checking accounts, investing them instead in repurchase agreements and other high-yielding investments, even if the money was available only as long as overnight. Also foreign banks, more lightly regulated and more highly leveraged than ours, began usurping U.S. strongholds by lending Eurodollars to multinational corporations at rates that U.S. banks couldn't match. Compared with that abuse, this country's vast ranks of small companies reward their bankers generously.

So now small businesses find themselves the center of attention. Jerome L. Roderick, director of the domestic lending division for Robert Morris Associates, a national organization of commercial loan officers, sums up the bankers' dilemma: "Ten years ago, a banker would sit back and wait for customers to come in the door. Now he has to go out and compete."

Mellon Bank in Pittsburgh, for example, has joined the fray. Only two years ago Mellon wasn't paying much attention to small business, according to Craig G. Ford, senior vice-president in charge of community banking. Mellon is a major international player and is this country's 16th largest bank by assets, but it also operates 110 branches in the six counties where Pennsylvania law allows it. Now it has formed a new division to pursue small companies in this territory.

Mellon has designated five officers at its headquarters to specialize in small business loan structuring and credit analysis. They help out whenever a branch lending officer runs into a small business loan application too puzzling to handle alone. "If you can generate the volume, you can allocate some specialists into the field," Ford says.

Even though the attention may be a lefthanded compliment, this new fad among bankers has meant some good news for small borrowers. Among the shifts occurring in the industry:

☐ Small firms are getting relatively better rates. That's perhaps hard to believe when the prime tops 20%. But they seem to be paying less of a premium over prime than they used to.

☐ Banks are abandoning short-term, roll-over credits in favor of longer-term commitments to their good customers. That allows borrowers to count on a line of credit for five or more years, without worrying that it could disappear at a loan committee's whim. What used to be short-term seasonal loans become medium-term working capital financing.

☐ For the first time, banks are designing cash management products and other electronic services specifically for small firms. Eventually, the advances in this field will bring to small companies the same savvy techniques that the large companies already use with such success.

In theory, stiffer competition drives down prices. The average price for borrowing money, of course, hasn't fallen during the past few years. But small business may be getting better rates than it used to compared to big business. Nobody says for sure, though, because interest rates alone don't necessarily mean anything. Compensating balance requirements make effective interest rates higher than what loan contracts state. And then there's the hubbub over whether prime rates are really prime: Some banks treat them just as bargain-

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Illustration on page 39 by Bunny Carter

ing chips in negotiating loans with large companies rather than as base lending rates.

Keeping in mind those caveats, the spread that small firms pay over prime has narrowed or even disappeared. Five years ago, according to Federal Reserve Board figures, loans of less than $100,000 commanded a couple of percentage points more than loans of $1 million and up. Today, according to the same statistics, the differential is nil. And that isn't just a figment of some federal statistician's imagination. Borrowers have noticed the change. In a survey of almost 1,000 INC. subscribers conducted last winter, small firms said their latest loan was, on average, within one-half point of prime.

"For middle-market companies, the cost of credit has decreased compared to large corporations," says Richard S. Bibler, executive vice-president of First Wisconsin National Bank of Milwaukee. "The risk premium has decreased. Where the premium for small corporations may have been three points above prime, now it's one point. The small business borrower may really be getting a bargain now."

That's going overboard. Nobody thinks a 20% prime rate is a bargain. But it's better than 23%. Federal Reserve Board economist Thomas F. Brady theorizes that bankers have hesitated to pass on the full burden of rising interest rates to small businesses. Instead, he suggests, they follow a "longer-run, profit-maximization strategy," which means helping your customers stay afloat during difficult times so that you'll still have customers when times get better.

"Historically, small business has paid a higher rate because of risk," says David A. Wollard, president of Florida's Southeast First National Bank of Miami. "But if a business was paying two points over prime when the prime was 10%, you just can't afford to charge him two over prime when the prime is 20½%. You can charge that, but the business will fail and you'll have a bad loan on your hands. So discretion being the better part of valor, you back off on the rates."

There are other plausible explanations. For one thing, a higher proportion of loans to small firms carry fixed rates than do loans for big companies. When interest rates rise, therefore, small companies' rates don't float upward as fast.

In addition, smaller banks, which lend mainly to small companies, tend to charge less than large banks whenever interest rates are rising. D. Bruce Adamson, chairman of the First National Bank and Trust Co. of Joplin, Mo., points out that this has been so since the Federal Reserve Board first allowed banks to sell six-month money market certificates to consumers in 1978. For smaller banks, these have since become a staple source

Steve McCurry/Gamma Liaison

Roderick: "The businessman is going to have a lot more to choose from."

of funds, locking in their costs for six months in advance. Larger banks, on the other hand, buy most of their funds at the going rate in very short-term money markets. When interest rates rise, small-bank rates lag behind. In August, when the big-bank prime was 20½%, Adamson was charging 18½%. Obviously, when rates fall, the advantage switches to the other side.

The renewed competition has spurred banks to help ease economic pressures on small business in other ways.

For instance, banks are offering more medium-term revolving lines of credit for working capital, in place of the standard 90-day notes. Typically, these are committed for one to seven years, though often secured by short-term assets such as receivables or inventory. "It's really a kind of long-term financing," says Roderick of Robert Morris Associates. "There's a source of capital available continuously to finance growth. It isn't called that. But it's done with an eye to getting the company up where it can get out of its working capital pinch."

Pennsylvania's First National Bank of Mercer County has started making loans like that. "Some of our revolving lines are running out to five years on a formula basis against receivables and inventory," says Stephen J. Gurgovits, executive vice-president. "We're getting away from 30-, 60-, and 90-day notes, away from due and payable in six months and rolling them over. At least one-third of our loans are structured like this now, and I expect that to grow to one-half by 1982.

"Financing now is more geared to be compatible with the cash requirements of the business," he says. "We've come through a very inflationary period, and if you take a business that's inventory-intense, its demands for credit actually have been growing. If you're financing its inventory needs or its general working capital needs and you're putting on 90-day notes, I think you're only kidding yourself. The company's needs for financing are growing, and you're trying to convince yourself that it's going to be a liquidating situation.

"We've also completely eliminated the need for annual cleanup," adds Gurgovits. "Cleanup just provides the opportunity for the bank across the street to extend our customer the credit."

John R. Barrick, one of Gurgovits's customers, switched from short-term notes to a seven-year revolving line of credit for an amount "well into six figures." Barrick, a metallurgical engineer, founded his metal recycling company, Pyromet Technology Inc. of Greenville, Pa., in 1978 and says annual sales are now about $7 million. "Before," says Barrick, "each time we required money, I would have to go in and sign a note. It took a great deal of time and effort, inconveniencing both the bank personnel and myself. Now we have a line of credit committed for seven years, secured by certain assets and inventory. The bank was reasonably satisfied with our business development. It was a way for the bank to give us a vote of confidence."

Other bankers mention that they're making more such loans. "We used to make a lot of short-term loans and roll them over all the time—but we were just kidding ourselves," says Embree K. Easterly, president of Capital Bank & Trust of Baton Rouge, La. "If the customer continues to grow, he'll probably never pay it down." Recently Easterly has started making three- to five-year term loans secured by customers' receivables. "In effect, they're capital loans," he says. Banking regulators don't frown on such evergreen loans, he says, if the receivables are turning over and are current.

The competition for small business bucks is also spreading into the chaotic realm of modern electronics. One of the more popular new bank products, requiring just a push-button telephone, allows a small firm to gain better control of its cash balances.

Mellon Bank, for example, calls its version Telecash. It works like this: The firm's financial manager calls a bank computer and asks for the day's checking account balance by pushing a sequence of buttons. After a computerized voice answers, he pushes buttons again to transfer any portion of the sum—even if it's in float—into a money market fund to earn top rates. The next day, if he needs the money, he reverses the process.

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Mellon charges 50¢ per transaction, with no minimum or monthly fee.

Only 200 Mellon small business customers are using Telecash so far, yet it's already outmoded. In June, the Bank of New York began test-marketing a system for small businesses that performs the same task without the phone call. When the company's checking-account balance climbs above $6,500, every extra dollar flows automatically into a money market fund. When the balance dips below that, the checking account reaches into the fund and takes back enough to bring it up to snuff.

Bank of New York got the jump on its competitors because it's the country's largest processing agent for money market funds. Thus its computer systems were readily adapted to the new job. So far, it's selling the service, which it calls Checkinvest, to companies with sales between $500,000 and $10 million in Manhattan and Syracuse, N.Y.

Unlike Mellon, Bank of New York charges $100 a month for the service. Thus it takes an average bank account balance of at least about $25,000 to come out ahead, depending on money-market payouts. "The average company with $3 million in sales keeps $30,000 to $50,000 in its bank account. Many don't realize it's that high," says a bank spokesman. Assuming money market funds pay 15% a year, a $50,000 balance would net the Checkinvest customer $5,325 a year after maintenance fees.

Many banks are working on their own version of Checkinvest. They take no joy in it, though. Such products threaten to eliminate the pool of cheap small-business money that the banks have only recently come to appreciate. "Some bankers believe that that's encouraging customers to take funds off their balance sheets and put them onto the balance sheet of an investment firm," says Kerry J. Ryan, vice-president and manager of

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INC. Special Report

BANKING IN THE '80s

Lynn Johnson Black Star

Barrick: "The bank gave us a vote of confidence."

TIPS FROM A BANKER

by Michael Celello

Fewer than 10% of prospective borrowers come to a bank adequately prepared. And bankers haven't the time to dig for the facts they need. Unfortunately, the safest thing in banking is to say no. You'll never get fired for that. Want to increase your batting average in the loan office? Here are a few tips.

☐ Pick your bank carefully. Does it deal mostly with larger corporations? Or is it a retail bank, one that aims to serve consumers and smaller businesses? If you pick the wrong one and wind up getting rejected, it will make it that much harder for you to get a loan at a second bank. Banks check credit bureaus, and the bureaus register their inquiries, so the second will know you've been to the well already and come back dry. Nobody likes to be asked second. Bankers are always afraid the first one knew something that they don't.

☐ Have a good accountant prepare a complete set of financial statements for your business, as well as a business plan and a personal balance sheet. If possible have him accompany you to the bank. The banker will have questions, and the accountant can respond to them more objectively.

Most small businessmen are myopic. They don't want to pay accountants. They tend to be aggressive optimists with a marketing or sales orientation, so they don't want to listen to someone they often view as a glorified bookkeeper telling them not to expand too quickly. But an accountant saves the banker a lot of work and shows him that he's dealing with a sharp businessman—one who knows enough to surround himself with expertise. If you come into the bank with an accountant and all the necessary financial information, it improves your odds of getting a loan by 75%.

If you don't go to an accountant, you'll probably settle for a loan with too short a maturity and wind up depleting your working capital. If your business is seasonal, you might fall into a cash-flow bind during slow periods. Then you'll have to return for refinancing, which may mean another round of up-front commitment fees and higher interest rates. You want to shoot for the maximum term you can get while maintaining profitability.

☐ Make an appointment. Many businessmen don't seem to realize that you don't just walk in off the street and ask for $100,000. The businessman who asks for an appointment shows he is business-oriented. You wouldn't make a sales call without first making an appointment—why do it with your banker?

☐ Demonstrate to your banker that you're a person of good character, especially if you're applying for a loan for the first time. A banker likes to know that you're civic-minded and respected in business and community circles. I have seen banks make loans because they know that the borrower is active in the Boy Scouts and goes to church every Sunday.

☐ Show that you don't have your head buried in the sand. A lot of businessmen know their business and their immediate community, but they're often not tuned to what is happening in the world. Pick up the *Wall Street Journal* and read trade journals so that you're knowledgeable about your entire industry and the economy as well as your business. Today, even a business that's been around 100 years can't be too confident.

☐ Be honest with your banker and ask him for the amount of money you really need. If you want to borrow $20,000 so you'll have $5,000 for an electronic cash register, $10,000 for a new delivery truck, and another $5,000 for working capital, that's fine. The bank may want to make three separate loans instead of one, keeping the money for the first two in line with their life expectancies and putting the line of credit in a separate category. Bankers don't like to lend extra money unnecessarily.

☐ Even the best credit prospects must be prepared to personally guarantee their loans. If a businessman isn't willing to put his assets on the line, why should a bank? Whether the business is a sole proprietorship, a partnership, or a corporation, it boils down to a few key people at most. Only giant companies like GE or IBM don't sign personal guarantees.

Michael Celello is president of the People's Commercial Bank in East Greenbush, N.Y.

BANKING IN THE '80s

Mellon Bank's data center division. "But others believe that since it's happening anyway, they'd rather have the customers do it through their bank."

As the easy money dries up for bankers, the profitability of their traditional main activity—taking deposits and making loans—is shrinking. They are looking toward increased direct fees from other services to fill the gap. They'd like financial services for small business to be one of the growth fields.

Adamson: Charging 18½% when the New York prime was 20½%.

Many of these services won't be new. Banks as well as computer service firms have been processing payrolls for companies for three decades, for instance. Other existing computerized services include lockboxes, sales analyses, pension accounting, credit investigations, and accounting packages for receivables, payables, inventory, and general ledger. "All these things have been sitting around—banks just haven't sold them very aggressively to small business," says Roderick.

What will be new is the way many of these become tied together or put "on line." For example, that old standard, the lockbox, metamorphoses into the "automated lockbox."

A lockbox is an arrangement in which a company's customers send their checks directly to its bank. The bank deposits the money speedily in order to take maximum advantage of the float. With the old-fashioned kind, the company doesn't find out how much money came in or when it did until it receives its regular account statement. With an automated lockbox, that information goes immediately into a computer that the company can tap anytime. Money that arrives today can be spent or invested today, electronically.

Cash management services are undergoing swift evolutions of this sort. Mellon's cash concentration service, for example, automatically transfers the balances out of a company's field accounts and into a central one each day. With a recent revision, it now can accommodate a standing order to move the funds only when they reach a specified level. "We probably won't be comfortable six months from now with the system we just rewrote," says Jerry A. Murphy, assistant vice-president for community business services.

There's still a long way to go. "It would be innovative for small companies to utilize the telephone bill-paying system that a lot of banks now offer for consumers," says Mary Pat Cottrell, vice-president for corporate services at Union Trust Co., of Stamford, Conn. "They could use it for business-to-business payments. The system provides a cash disbursement record as well as year-to-date information on expenditures with that particular vendor. The system is there and it's generating enthusiasm on the part of accountants that serve small companies. But a lot of telephone bill-paying systems are very labor-intensive for the bank, so some are very reluctant to solicit use by the small business sector."

One useful service that small businesses can buy now, but haven't, is automatic account reconciliation. This service saves hours or even days reconciling a company's checks at the end of the month. But only 4% of INC. subscribers use it. INC.'s survey also revealed that just 13% of our subscribers use any kind of electronic money transfer at all. That total seems certain to grow as banks sell cash management more aggressively to small business and as firms learn the advantages of managing their money more closely (see page 56).

The emergence in the last few years of inexpensive microcomputers will make on-line electronic banking practical for many small companies that haven't used it before. Microcomputers afford vast flexibility compared to telephone button-pushing.

"Right now, the industry is pushing home banking," comments Murphy of Mellon Bank. "My view is that home banking is never going to be the success that people say it is. It will blossom very quickly, then stagnate. And that's when the multiplying effect will take place in small business. Everybody's going to start being curious about what they can get."

Businessmen are justly suspicious of pie-in-the-sky promises. Whether electronic banking provides a panacea for

(continued on page 50)

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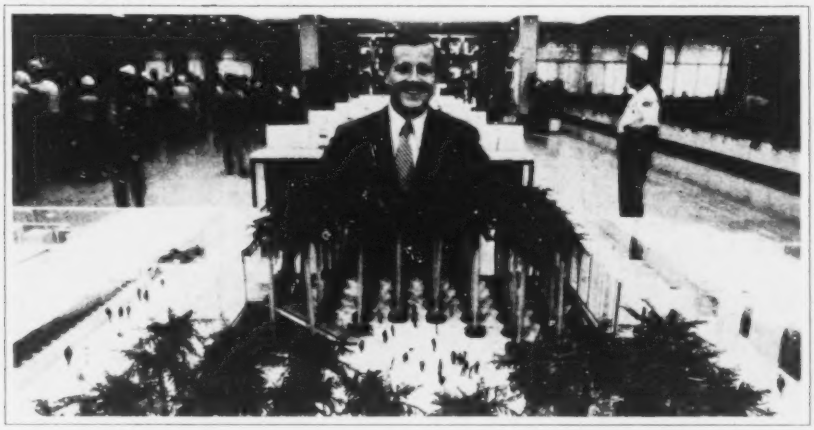
BANKING IN THE '80s



Flip Schulke/Black Star

Wollard: "Banks coming into the middle market keep redefining what it is."

HOW BANKERS VIEW SMALL BUSINESS

(Source: INC. survey of 150 large and regional U.S. banks)

These responses come from bank officers responsible for small business accounts. The questions were "open-ended"—that is, not multiple choice: Respondents gave these answers unaided by suggestions from the interviewer. An independent research firm conducted the interviews by telephone in July and August of 1981. In order to avoid possible pro-small business bias, the interviewees weren't told that INC. had commissioned the study. Totals exceed 100% because the bankers were invited to give more than one response to each question. Omitted are "don't know," "no answer," and items mentioned by fewer than 1% of the respondents.

Question: What were the major reasons for rejecting small business loan applications over the past year?

	% of respondents who mentioned factor
Undercapitalization or too much debt	32%
Lack of collateral	20
Inability to demonstrate source of repayment	15
Poor credit history	15
Inadequate financial information	12
Weak management	8
Applicant lacks experience in his field of business	7
Poor track record or poor profitability	7
Insufficient cash flow	5
Unprofessional financial statements	2

Question: How would you characterize the ideal small business borrower?

Good capitalization, decreasing debt-to-equity ratio, or retains earnings in business	31%
"Good management"	22
Good profit history	21
Good accounting or financial statements	13
Knowledge or experience in this business or product area	11
"Good character"	11
Good credit history	9
Steady growth or growth potential	9
Good cash flow	7
Strong or increasing sales revenue or market share	5
In business a reasonable length of time	5
Good collateral	5
Keeps bank informed	4
Good planning	3
Good product, market, or industry	3
Liquidity	3
Personal equity invested in company	1

Question: What are the major problems in dealing with small business?

Undercapitalization	19%
Inadequate or unreliable records	15
Lack of capable management	15
Inexperience or lack of financial knowledge	11
Inadequate credit rating	5
High interest rates	4
Don't use bank services to full advantage	4
Poor planning or overextension	3
Insufficient profit margins	3
Poor cash flow	3
Unaudited financial statements	2

small business cash woes remains to be seen. But an explosion in the variety of products and services seems on its way. The conscientious manager will make a point of shopping around and trying them.

Indeed, that applies to all aspects of the banking world. With many banks offering small companies better terms than they did before, it may be time to reevaluate one's present bank. Businessmen who haven't visited their bank's competitors for a while might be pleasantly surprised at the reception they're given today.

The big banks plunging anew into this market maintain flexible views on what's "small." While some are devoting increased attention to companies in the $500,000-to-$10-million sales range, most have set their sights on what they call the "middle market," usually defined with an upper limit of $100 million in annual sales. That may sound huge to many INC. readers, but it's peanuts as far as the nation's top 100 or so banks are concerned.

"Banks now coming in after the middle market keep redefining what it is," says Wollard of Southeast First National Bank of Miami. "It used to be $25 million or more in sales; now they're happy to talk to a company with $10 million in sales." Chemical Bank in New York pegs its middle-market minimum at $5 million in sales. Carol J. Parry, Chemical's senior vice-president in charge of Manhattan middle-market companies, says that three-fourths of her customers have less than $20 million in sales.

Small banks, whose traditional small-company market is threatened by the giants, will be fighting back. Though they haven't the same technical power to offer their customers, they do wield one significant weapon against their giant brethren. "We have more stability among lending officers," says A. Andrew Boemi, chairman of Madison Bank and Trust Co. of Chicago. "We don't have the turnover you get at the major banks, which have to shift those young M.B.A.'s around every year for the experience. Small business owners like to be able to come in here and talk to the chief executive officer."

The small business sweepstakes is on. With a host of predators stalking the commercial banks' once exclusive domains, and financial seers predicting the fall of interstate banking prohibitions with increasing frequency, it doesn't seem likely to end soon. "We face a real competitive free-for-all," says Roderick of Robert Morris. "The businessman is going to have a lot more to choose from."

BANKING IN THE '80s

WHEN THE BANK SAYS NO

For this report, INC. surveyed 150 of the largest banks in the country (see table on page 50). Among the questions we asked were: What are the major problems in dealing with small businesses? What were the major reasons for rejecting small business loan applications over the past year? And, what are the characteristics of the ideal small business borrower? No matter how we posed the question, the bankers' message came through loud and clear: Small business has too much debt!

That may sound odd coming from people falling all over each other to lend you money. But high debt-to-equity ratios signal risk, to which bankers are highly averse. "Understand that banks are not really in the risk-taking business," says George S. Arneson, president of Arneson & Co., a Kansas City, Kans., consulting firm. "They're lending someone else's money, and when you look at what they're paying for their money and their administrative costs, their gross margin after bad debts is not that great."

Last year, the National Federation of Independent Business surveyed several thousand NFIB members about their banking relationships, and it made the same discovery as INC. Among the 377 who reported recent loan refusals, the most frequent reason given by the bank was insufficient equity or too much debt.

The solution isn't to get more equity. That would be ideal, but most small businesses stay highly leveraged precisely because they can't find equity. Rather, getting around bankers' reluctance to add to your debt involves a combination of less-than-ideal fixes.

Frequently banks send their rejected loan applicants to a commercial finance company. The bank may even own the finance company, making such referrals a lucrative proposition for it. Occasionally finance companies come through with cash when banks won't. But they demand strong, convincing collateral and charge four or five points over prime to boot. These lenders don't judge you by your chances of growing and prospering; they just count up what your assets would be worth on liquidation.

At banks, collateral fills a different role. A loan officer seeks above all a continuing customer; he'll ask for some collateral just in case he's wrong. Frequently, the pledged assets wouldn't recoup a bank's full investment, anyway.

"No bank that I know of would make a loan secured by a basket full of gold bricks if they really thought they would have to sell the bricks," remarks Richard S. Bibler, executive vice-president of First Wisconsin National Bank of Milwaukee. "No matter how much collateral you pile on the loan officer's desk, he's not going to make the loan if he thinks he'll have to liquidate. Banks aren't pawn shops."

Consultant Arneson cautions against pledging all one's assets for a single loan. "Many companies, when they come in to borrow, haven't planned for enough," he says. "They may ask just for the minimum they want, and most likely it isn't adequate to do the job to begin with. If you don't borrow enough the first time, you almost always have trouble getting your next loan, because all your assets are tied up and you haven't any-

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DO BANKERS DO THEIR JOB WELL?

Small business isn't just like big business except smaller. It's fundamentally different. For one thing, small business uses more debt. According to Federal Trade Commission statistics, the average small manufacturing corporation with assets under $5 million showed a debt-to-equity ratio of 1.23 in 1978, while all companies, on average, had a ratio of 0.93. Or, for every $1 in equity, small manufacturing companies carry at least 30¢ more debt than large ones. The figures for service companies are similar.

Are bankers wrong to hold smaller businesses to the same capitalization standards that they set for big business? Do they fail to look beyond debt-to-equity ratios for the real strengths of a business? Should they be willing to take more of a chance on small enterprises? Some consultants think bankers don't do their jobs very well when it comes to small business.

It's canon in the banking profession that a loan officer's personal opinion of his customer plays a crucial role in lending. In INC.'s survey of 150 large banks, respondents frequently

William Armbruster

Poindexter: "It's not the amount of money that makes or breaks a business."

mentioned management character, integrity, and experience as important qualities in a loan applicant. But evaluating a small company's management takes lots of a banker's time and energy, compared to the return he may foresee. "For most bankers, the measure of how good you are as a manager is how you stack up against industry ratios," says Sharon F. Poindexter, a Wichita, Kans., consultant who runs small business financing seminars for the National Association of Bank Women. "And the performance of many small businesses will not fall into the positive range of acceptance if you're looking only at industry ratios."

Poindexter urges applicants who have been rejected for a loan because of undercapitalization to pursue the banker with more questions. "Have the banker clarify what he means by undercapitalized," she says. "It's not the amount of money that makes or breaks a business. I've seen lots of businesses that had lots of money and still went under. It's a matter of managing the capital that's available. Sometimes it's a matter of restructuring how you're going into the marketplace." Exchanging these sorts of ideas with a banker, she counsels, builds a relationship that may clinch the loan.

"The average borrower doesn't know the basis that the banker uses for his decision," says Edward H. Pendergast, president of Financial Management and Consulting Corp. in Boston. "And I don't think the

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thing left to pledge."

For companies with truly insufficient equity to please loan officers, the mission becomes cajoling more use out of the existing capital base. One crucial variable is net working capital (current assets minus current liabilities). That's the amount of equity used to finance day-to-day operations, the rest being tied up in long-term assets such as plant and equipment. Successfully juggling inventory, receivables, cash, and payables can create a sizable chunk of net working capital where little was before. That could warm the heart of a lending officer, who's probably been inculcated with the principle that net working capital should be about equal to current liabilities.

Bernie J. Grablowsky, a professor of finance at Old Dominion University in Norfolk, Va., surveyed Norfolk small businesses with up to $5 million in annual sales and found that they kept an average of $30,000 sitting in the bank all year for each $1 million in sales. If money markets are paying 15%, then that sum could be earning $4,500 a year in interest. Put to work financing current operations—such as by buying more inventory and paying for additional labor—it might earn several times that much.

And that was only the money that these business people knew they had. Often entrepreneurs don't really know how much cash they have available. The float on checks sent out and on deposits made leaves a fuzzy area around most business checking account balances.

Hank Young/Black Star

Arneson: "Banks are not really in the risk-taking business."

Perhaps some of these cash balances were fulfilling compensating balance requirements on loans, but probably not many. For example, finance professor Philip L. Cooley of the University of South Carolina, along with Richard J. Pullen of Canada's Confederation College, surveyed 180 companies across the United States who market petroleum products. They found that among those with less than $1 million in assets, only one in five was required to keep compensating balances. For those with over $1 million in assets, the proportion was about one in four. These figures probably resemble those of small companies in other industries.

Another solution to the cash crunch, which many businesses rely on heavily but perhaps don't appreciate enough may be to "borrow" from suppliers.

There are some creative ways to do that. Stephen J. Gurgovits, executive vice-president of the First National Bank of Mercer County in Sharon, Pa., writes letters of credit for some of his customers. That's a contract, used widely in international trade, guaranteeing the suppliers payment in case the buyer of the goods defaults. Gurgovits says that some suppliers offer their customers better terms on advances than the bank could give. "We look at it this way," he explains. "It gets a better deal for your customer, and

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banker always tells him. Don't be ready to take no for an answer. Ask why you were rejected."

Arthur F.F. Snyder, president of Boston's Commonwealth Bank & Trust Co., puts it more bluntly: "I have to admit that many bankers are chicken. They are afraid of being candid. They don't come out and say, 'Fella, I don't like this.' They say, 'What you need is more capital,' when they didn't like something else that you will never know about."

California's former deputy superintendent of banks, Derek Hansen, thinks he knows why bankers emphasize debt-to-equity ratios so strongly. In theory, a lender can take slightly higher risks if he charges a slightly higher rate for the loan. In a given portfolio of loans, the return from the vast majority of successful risks offsets the occasional bad loan. In practice, says Hansen, banks don't think like that. They don't because banking regulators don't let them.

When regulators spot an above-average loss rate—three-tenths of 1% of a total portfolio is typical, and twice that is considered dangerous—they impose strict remedial measures, such as requiring the bank to raise additional capital. They don't ask whether the bank earns enough on its good loans to compensate for the losses. As a result, "Banks don't have the ability to lend on a risk-reward curve," Hansen says. "The system doesn't have anywhere in it a lender who can take even moderate degrees of risk—such as a 1%, 2%, or 3% loss rate instead of three-tenths of 1%.

"A classic example is a bank we had in California a few years ago that was doing very well, but showing a high loss rate," says Hansen. "They charged enough on their loans to cover that risk, so their bottom line was better than other banks. But the banking system regulatory authorities couldn't deal with that—they were classifying almost all of those loans.

"This conservative bias favors consumers whose borrowing needs are generally less risky than businesses, whose loans can often be collateralized with automobiles or other assets," says Hansen. "It favors real estate, which is in itself a form of insured security. It favors large businesses that can often provide security from mature, profitable company operations and assets to secure borrowed capital to cover newer, more risky ventures. It does not favor entrepreneurship."

WHY YOU NEED DEBT TO GROW

Managers of small companies sometimes wonder why a successful company with an unbroken record of profits is short of cash. But, in fact, growth in sales increases the need for financing. A small company with, say, $100,000 in assets ($60,000 in current assets and $40,000 in fixed assets) that is financed by $30,000 current liabilities and $70,000 of owner's equity usually needs more assets to expand its operations and, through such expansion, increase its sales.

Let's assume that this company wants to double its sales. To support that increase, let's further assume that assets have to be increased to $150,000. If current liabilities could be expanded by $20,000 then $30,000 must be found. The two main sources for this $30,000 are reinvested earnings and debt. If the income realized by the firm after taxes is $10,000, and the owner decides to reinvest it completely, there is still a need for $20,000.

From "14 Financial Pitfalls For Small Businesses," by Moustafa H. Abdelsamad, Guy J. DeGenaro and D. Robley Wood, Jr., in *S.A.M. Advanced Management Journal*, Spring, 1977.

Tom Barr/Black Star

Gurgovits: "We've eliminated annual cleanup across the board."

they pay us a fee for the letter of credit."

A letter of credit costs a fraction of a loan in the same amount because the bank commits none of its funds to the transaction—assuming, of course, the customer doesn't default. The fee is an insurance premium; the bank acts exclusively as insurer.

There's a good reason why suppliers frequently offer their customers much more generous terms than a banker would. For example, suppose a supplier sells $10,000 worth of goods to a customer monthly on 30-day terms. In a year, he sells $120,000 worth of merchandise to him. If the customer ordinarily pays in 30 days, the supplier regularly keeps $10,000 at risk in outstanding receivables to his buyer. If the supplier makes a 10% before-tax profit on his sales, then he earns $12,000 a year on the continuing $10,000 invested in the receivable.

That's a 120% return on his investment. If a bank, on the other hand, were to lend the customer $10,000 to finance the payables for 30 days over the course of a year, it could earn only, say, 15% to 20%, or $1,500 to $2,000, on the same investment.

This supplier is a good candidate to approach for longer terms. Extending them to 60 days would still earn him 60% of his investment. Why should he cut his return in half? He might be very amenable to giving a good customer some leeway during trying times.

Supplier credit, in fact, is a bigger source of debt capital to small manufacturing firms than bank loans. According to the Federal Trade Commission, small business trade accounts and notes payable added up to 17.2% of their total assets in 1978, while bank loans of all kinds accounted for 16.5%.

By borrowing money when cash could be squeezed out of current operations, a small business pays twice: Once to the banker, and once by losing the opportunity to use idle dollars in the business. Plenty of small business managers recognize that they could manage working capital better; they just don't have the time, they say. The typical financial officer of a small company has his hands full just maintaining the books, placating the creditors at the door, and keeping the company solvent.

But many entrepreneurs need to take time out to brush up their financial knowledge. With plain old cash worth as much as 20% a year, all the old textbook techniques of managing receivables, payables, cash, and inventory are worth two to three times more than just a few years ago. Some who seek money from banks could find it instead in their own backyards. Many have no choice. □

Doran Howitt is an associate editor at INC.

HOW GOOD A CASH MANAGER ARE YOU?

One banker says that the principles of cash management are easy: "Collect fast, pay slow, and invest in the meantime." But sometimes it's just the opposite. Do you know when? For an indication of how good a cash manager you are, try this test:

You buy merchandise on standard terms of 2/10 net/30 (a 2% discount for payment within 10 days, or the full amount due in 30 days). Before reading the next paragraph, choose from among the following possible answers the approximate cost, on an *annual* basis, of passing up the discount and paying in 30 days instead: a) 2% b) 8% c) 20% d) 24% e) 36% f) 72%.

To find the correct answer, first assume you earn a 2% return on a 20-day investment—that is, giving up your cash 20 days early. Then multiply by the eighteen 20-day periods in a year (assuming a 360-day year). It comes out to 36%. Unless you can earn more than that on your money, you should *always* take your cash discounts. Even if you have to borrow at 20% interest in order to do so, you come out ahead.

WHERE ARE YOUR RECEIVABLES RIGHT NOW?

Does your company have to write off some receivables as bad debts? If so, did you let a collection agency try its hand? Many small business managers are reluctant to hire collection agents. An agency's commissions often run as high as 50% of what they bring in, which sounds exorbitant. Managers figure that by "sitting" on the debts, they might eventually collect all.

That attitude is unwise. An illustration shows just how worthwhile a collection agent's efforts can be. Assume a firm is in the 46% tax bracket, and that the collection agent charges a 50% commission. The firm *loses* $54 after taxes on every $100 written off, whereas it *gains* $50 after taxes for every $100 the collector retrieves. That's a profit differential of $104 for every $100 the agent collects. At lower tax rates the differential widens.

Observes Edward H. Pendergast, president of Financial Management and Consulting Corp. in Boston: "A lot of good-sized companies don't manage their receivables properly because they don't get around to following up on them until after they've sent 3 letters. Any good cash manager who needs cash is going to ignore the first 12 letters."

Marjorie Nichols

Pendergast: "Don't be ready to take no for an answer."

"TO SECURE THESE RIGHTS..."

This is the first of a series of articles that will appear from time to time in this space on the general subject of "The Federal Turnaround We Need." In them, we'll review some of the issues underlying federal policies on a wide range of subjects: taxes, capital, credit, government competition, data collection, mergers, technology and patent policy (see National Affairs, page 35), and procurement, among others.

There are several reasons for this series:

First, the cumulative impact of federal policies—and lack of policies—has made our national government a dangerously strong force for domestic economic concentration. It needs to be turned into a force for economic diversity.

Second, this trend in government policy has come about, in part, because of a failure of small business advocates to make their case as clearly as possible, and to show that it's in the national interest to promote the welfare of small business.

Third, small business has fallen prey to the illusion that it must ignore government because it can't influence what government does, and that economic policies that seem good for all business will automatically take care of small business's needs.

Fourth, the leaders of America's large companies have not yet read the clearest lesson of modern Western Europe's economic history: The shrinkage of the small business sector is generally (from my reading, invariably) followed by strong moves toward the governmentalization of the remaining large-business sector. "What's good for small business is good for all business" has turned out to be a truer maxim than "What's good for all business is good for small business."

Fifth, the self-righting process of the American government's system of checks and balances still isn't working well enough for small business. Neither liberals nor conservatives, Republicans nor Democrats, have yet been made responsive to the needs of small business. Neither the Congress nor the courts, nor, least of all, the executive branch, has moved to arrest the swing of federal policy away from small business and toward both government and government-sized business. All the branches of our government, and both political parties, have been content to deal with national policy as a choice between public bureaucracy and corporate bureaucracy. But there are essential national goals that can best be met by a larger independent, entrepreneurial small business sector.

The best place to see what these goals are, and to understand the issue between small business and government, is right at the beginning of our country. Let's start with these words:

> We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty, and the pursuit of Happiness. That to secure these rights, Governments are instituted among Men, deriving their just powers from the consent of the governed.

Among the many personal rights that I want to preserve and expand for myself, my children, and my grandchildren are two that are particularly relevant to the survival of independent small business.

The first is simply the right to start, own, manage, and make my living from my own business if I want to do so.

The second is the right to live in the most diverse economy possible, with the largest possible number of employers, and the widest possible range of owners and jobs.

These two rights, if I have them, go far toward strengthening my ability to enjoy many other rights. They give me a feeling of

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THE BUCK STOPS HERE *(from page 180)*

personal independence, a sense of having real freedom. If these rights are maintained, I know that whether I work for a big business, a big government agency, a big university, a big union or charitable institution, or a small company owned by someone else, I can always quit and do something else. The larger the number of employing units, the greater my freedom will probably be. (I say "probably" only because there are other things to take into account, such as the possibility that there will be too many people competing for too few jobs.)

The two rights I have just stated have been pretty much taken for granted throughout our history. Yet I have not found a statement of them as rights that has been given the dignity of express legal protection by either the Constitution or the laws of the federal government and the states. Nor is there any theory I know of that finds them clearly and necessarily implied by any other legally protected and acknowledged right. If any lawyers or other readers can enlighten me further, I'd be delighted.

The larger the share of the economy that is not divided between government and government-sized business, the more meaningful both of these rights will be. The more prosperous, profitable, and numerous private small and medium-sized businesses are, the more people there will be for whom the sense of freedom is real. The more room there is in the economy for new businesses to start and succeed, the less we will need to worry that economic concentration will lead to the loss of personal liberties.

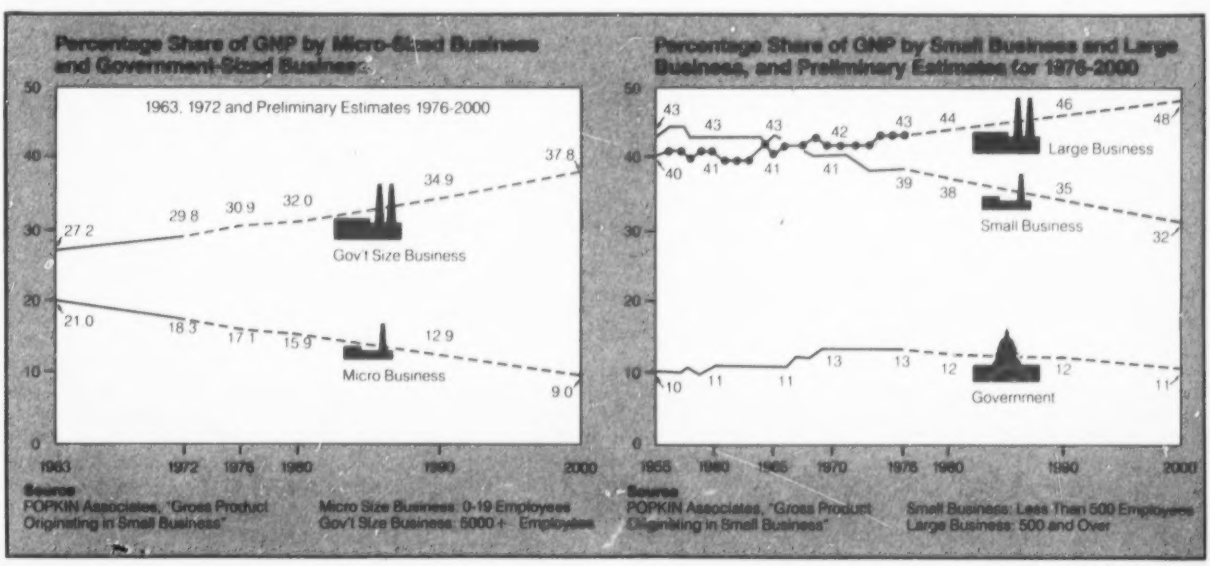
At the federal level, there seems to be more and more dangerous insensitivity to these rights both in the career bureaucracy and among political appointees. As federal preoccupation with foreign policy, defense, and the world economy increases, less and less attention is being paid to the impact of federal actions on the small business sector. During the Carter Administration, only the vigilance of a congressional committee and small business advocates in the private sector prevented a proposed foreign trade agreement from stripping domestic small business of important federal procurement rights. The most shocking thing about the incident was that those concerned with making the policy were not even aware that they should have been thinking about its effect on small business.

> The larger the number of employing units, the greater my freedom will probably be.

The current administration has been urged to oppose the bill I have discussed here several times—S. 881, which is sponsored by Sen. Warren Rudman (R-N.H.) and 81 other senators, and which requires certain federal agencies that finance nationally needed research and development in the private sector to spend minimal amounts with small business. Every opposition argument is specious or conjectural in the extreme. At bottom, the bureaucracy is saying that it has a "right" to spend this money exactly as it damn well pleases, and that this "right" of theirs is more important than the most minimal assurance that there will be some effort to encourage diversity in technology.

The case for small business—and for federal policies more favorable to it—does not rest on my assertion of theoretical personal rights alone. It rests also on "hard" arguments like the importance of technological innovation, of strengthening competition, of creating jobs, improving the balance of payments, and expanding the size and diversity of our industrial base for defense protection.

In future issues, we'll take some of these arguments and try to define further the two rights I've outlined. In December, Robert Berney will deal in our Economic Issues department with the problem of the federal government's data collection and reporting on small business. In that same issue, I'll discuss further in this space the problem of holding elected and appointed officials accountable for securing these two rights. We should ask of every federal program that affects small business, "Will it help to secure or will it weaken these rights?" We need our government to acknowledge its obligation to small business—not to guarantee that everyone who tries to run a small company will succeed, but to see to it that its economic policies give as many of us as possible the opportunity to try. □



Geoffrey Hodgkinson